

A REVENUE-RAISING PLAN FOR NEW YORK

by Howard Chernick

Preface

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In recent years, the federal government has relegated increasing responsibility to state governments. It has accomplished this goal in some important areas, most notably the welfare reform legislation passed in 1996. States have already been required to increase expenditures on a number of fronts, with the greatest pressures resulting from growing Medicaid costs. Rising school enrollment has further strained state budgets, as has increased demand for lengthier criminal incarcerations, resulting in rapid growth in spending on corrections. Although spending demands have increased, so has state revenue. In contrast to the projected decline in federal tax revenues, combined state and local revenues increased from 9.8% to 10.8% of the gross domestic product between 1979 and 1996.

Aside from maintaining current services in such areas as health care and law enforcement, there is also the question of funding for public investment—spending on infrastructure, education, and training. Although federal funds have often been available, most public investment spending is performed by state and local governments. If there is to be more public investment, states will certainly play a central role.

Important evidence attests to the value of public investment in general economic growth, but unfortunately such investment has been declining in the United States for the past 25 years. Under the latest budget agreement passed by Congress, projections indicate

a continued decline in public investment for the foreseeable future. If the size of the workforce also declines relative to that of the population as a whole (as many expect), productivity growth spurred by public investment will be even more necessary to ensure growing standards of living.

The recent gains in the national economy are doing much to obscure these basic trends. Employment has risen and state budgets are in their best shape in years. In fact, budget surpluses have become common and have led to proposals for state tax cuts. New York has already cut its taxes, and proposals are expected in Wisconsin and elsewhere.

Unfortunately, two basic facts about these tax-cutting proposals commonly go unappreciated. One is that budgetary surpluses have been made possible by a peak in the business cycle that cannot last indefinitely. A second is that, in the long run, trends in health care and demographics will eventually place renewed pressures on state revenue systems. Tax increases inevitably will be considered and made all the more necessary if states choose to cut taxes now.

Beyond the current economic boom, therefore, lurks the question of how to best reform state revenue systems. Although state tax systems typically endure the closest scrutiny when they fail to produce sufficient revenue, they should not be spared analysis and evaluation during less dire times. In light of the budget deficits anticipated by experts in the field of state and local finance, the Economic Policy Institute commissioned five papers to address the question of how states can best revise their revenue systems. The authors of these papers do not necessarily advocate such increases. They do, however, try to describe the best way of increasing state revenues while simultaneously improving the design of state tax systems. As such, these papers provide insight on tax reform irrespective of revenue goals and could be used for guidance in either revenue-neutral reforms or to replace local tax systems.

The scale of the problem addressed in these papers is large compared to the usual preoccupations of state legislatures. This choice was deliberate. These papers mean to shed light on basic deficiencies in state tax systems, not merely suggest ways of modestly boosting revenue. The latter would be a simple exercise requiring little analysis. For the specific states examined, however, these papers provide guidance in preparing for imminent structural deficits.

It is hoped that this series, focusing on state revenue programs in Illinois, Maine, New Hampshire, New York, and Wisconsin, will help launch a constructive debate on state-level tax reform. Although some of these states are more hard-pressed to examine these issues than others, it is safe to say that, sooner or later, every state will have to grapple with these tough decisions.

Introduction

New York State has enacted a series of tax cuts in the 1990s, but spending trends indicate that these decisions will have to be revisited in the not-too-distant future. Trends in health care and demographics, among other factors, are expected to cause spending to outpace public revenues, creating structural deficits in the state's budget. This report proposes basic tax reforms that can simultaneously close the revenue gap and improve the state's tax structure. Although other solutions are possible, this report endeavors to highlight weaknesses in the design of New York's tax system and illustrate their costs in terms of foregone tax revenue.

The tax cuts (mostly enacted in 1994) reduced state revenue by \$3.9 billion in fiscal year 1997 and a projected \$6 billion in 1998, according to the New York Department of Taxation and Finance. These reductions equal more than 20% of general fund revenues and 10% of total state revenues. About two thirds of the cuts have come from the personal income tax, New York's largest revenue source. In 1991, every \$100 of personal income was subjected to a state tax of \$4.31, but by 1996, this tax revenue had fallen to \$3.40 per \$100 of personal income, the lowest state income tax burden since 1981. Total New York tax collections in 1996 were equal to 6.8% of personal income, the lowest overall burden in the state since 1972. Although New York is widely regarded as a state with high tax rates, state taxes as a percentage of personal income are now below the national average (U.S. Department of Commerce 1996). While the state taxes alone are no longer particularly onerous in New York, the *combined* state and local tax burden continues to rank at the top of all states — at least 35% higher than the national average (U.S. Department of Commerce 1994).

As a result of these cuts, the state's revenue flow has seen a substantial reduction relative to the size of its economy, yet it has enacted no comparable cuts in its public spending. If the economy were not at its current peak, the state would face a structural gap between citizen demand for public expenditure and the revenue needed to support those demands. According to at least one estimate, the entire \$3.9 billion budget gap that New York faced in FY 1996-97 was due to the tax cuts in 1994 and 1995 (Mauro 1997). The magnitude of this gap has been temporarily obscured by an unanticipated increase in income tax and federal grant revenues. The tax windfall has provided revenue at least \$1 billion over initial projections for 1997 and 1998. (Wall Street's extraordinary performance in 1996 and the first part of 1997 provided this unexpected boon.) The gap between expenditures and revenues has also been temporarily bridged by using more than half of a recent \$730 million federal block grant, originally earmarked for welfare, to supplement the general budget. The state ended up with a cash surplus of \$1.4 billion in 1996-97, and \$1.36 billion in new revenues for 1997-98.

Despite their magnitude, these recent windfalls only temporarily mask the structural gaps created by the tax cuts, and they will not be sufficient to maintain the existing level of public services. Significant spending reductions have already been required, concentrated mostly in the Medicaid program, state aid to local governments, and higher education. When revenue drops, expenditure needs do not simply vanish, and the state has now begun shifting costs to local government and individuals. The share of elementary and secondary education financed by the state has declined from 43% in 1988 to 37% in 1993

(U.S. Department of Commerce 1994). As a result, the loss of state aid has caused local property taxes to climb. The cost of public higher education has also been shifted, with students paying ever-increasing tuition fees. If the proposed tuition hikes for 1997-98 had been accepted by the legislature, tuition would have increased by 40% at the State University of New York and the City University of New York in the last two years.

In response to these significant changes in the state tax revenue system and its undeniable effect on the state's ability to maintain public services, this report proposes a set of increases in taxes and fees which, if implemented immediately, would restore about \$3 billion to annual revenue flows, or nearly 10% of next year's general fund spending.

Taxation Principles

A number of groups have argued that the tax cuts New York enacted in the 1990s are both inefficient and unfair — inefficient because the foregone public expenditures are worth more than the increased private income, and unfair because those with the highest incomes have enjoyed the greatest tax reductions. While on a percentage basis the income tax rates have been reduced more for low-income than high-income taxpayers, the cumulative reduction in tax burdens has been much larger for high-income taxpayers.

In order to address these issues and make the best set of recommendations, this proposal evaluates state taxes and fees using the traditional criteria for a good tax system: equity, efficiency, stability, and responsiveness. (A fifth criteria, not discussed here, is ease of compliance.)

Equity: Tax code equity entails treating individuals equally as well as distributing the tax burden fairly among taxpayers with different income levels. The most recent comprehensive study of state and local taxes in the U.S. found that New York's tax structure is regressive, although less so than that of the average state (Citizens for Tax Justice 1996). In any state's tax structure, income taxes constitute the most progressive element. The reductions in New York's income tax since 1995, coupled with the increase in local property taxes, have almost certainly made taxes in New York more regressive.

In considering the equity of this proposal's recommendations, the impact of the whole must be considered over its individual parts. Some of the suggested changes in taxes may be regressive, but, as a whole, the overall package pushes the entire tax and fee system in a more progressive direction.

Efficiency: An efficient tax system is one that raises enough revenue to cover expenditure needs but does so in a way that minimizes wasteful distortions in economic behavior. In general, efficiency is achieved by taxing all sources of income or types of expenditures at the same rate and by avoiding very high tax rates on particular economic activities. A broad base for taxation reduces the incentive to shift resources into economic activities just because they are favored by the tax code. It is also well known that distortions from taxation increase more than proportionally to any increases in tax rates. These considerations lead to the recommendation that, when attempting to increase state revenues, it is desirable to broaden the base of taxation rather than simply increase rates, and it is best to employ a mixture of revenue increases from several different taxes rather than focus on only a single tax.

Stability: Stability refers to the steadiness of tax revenues year by year and is enhanced by a balanced portfolio of tax sources.

Responsiveness: Responsiveness refers to the elasticity of revenue growth in response to growth in the state's economy. If revenue's growth rate is lower than that of the economy as a whole, but demand for public service continues to grow at the economy's rate, then a state will face a continuous series of fiscal crises. Cuts in income tax rates have substantially reduced the revenue elasticity of New York's tax system to the point of introducing a large and growing structural gap between revenues and expenditures.

Not surprisingly, there are potential conflicts and tradeoffs between the various objectives. The most important tradeoff is that between efficiency and equity—the extent to which a state's competitiveness and job-generating capacity are adversely affected by the level of taxation and the progressiveness of tax burdens. This tradeoff is also the most difficult to evaluate. Proponents of tax cuts often believe that reducing income taxes is an effective way to encourage growth. The revenue consequences of such cuts are dramatic, and there is little evidence that they help to stimulate a state's economy (Carroll and Wasylenko 1994; Chemick 1997), especially since lower taxes usually mean reduced state spending on the public services beneficial to a state's economy.

Spending increases should not continue to be financed by tapping special reserve funds. New York relied heavily on this practice in the early 1990s, and such funds are now largely exhausted. Moreover, such sources only provide one-time budgetary relief, representing no permanent increase in revenues. The major source of such funds in the past has been the New York State Insurance Fund, which provides workers' compensation insurance to public and private employers. The Insurance Fund's revenues are derived entirely from employer premiums and investment income. Since 1983, New York has borrowed over \$1.6 billion from the reserve accounts of this fund. The economic cost of using insurance funds to finance deficits in the general fund is that it increases required employer premiums, thus raising the cost to firms of hiring new workers. Given the slow employment growth in New York, any policy that raises labor costs should be carefully scrutinized.

A Proposal to Increase New York Revenues

New York stands out from other states both in its level of taxation and in its reliance on personal income tax. As shown in **Table 1**, more than half of all state tax revenue comes from personal income taxes. (Only Massachusetts has a higher percentage.) By contrast, New York gets a relatively small share of its revenues from the general sales tax (only about 20%, compared to a national average of 32.4%) or the direct taxes on motor fuels (U.S. Department of Commerce 1994). These disparities would seem to suggest that any package of tax increases should emphasize sales and excise taxes.

However, careful consideration of alternative tax options, both in terms of revenue productivity and the principles of good tax policy, leads to the conclusion that the only feasible way to increase state revenues will be to further raise personal income tax rates. The bulk of this study's proposed tax increase, some 78% in all, stems from recommended changes to the personal income tax. Of that total, about \$1.77

TABLE 1
New York State Revenues,
Fiscal Years 1986-87, 1990-91, 1995-96
(millions of dollars)

Tax	1986-87		1990-91		1995-96	
	Amount	Percent	Amount	Percent	Amount	Percent
Individual Income	\$12,238	50.7	\$14,516	52.1	\$16,998	50.7
Consumption/Use	\$6,604	27.4	\$7,664	27.5	\$9,153	27.3
Sales and Use Tax	5,045	20.9	5,642	20.2	6,954	20.7
Hotel/Motel Tax	—	—	46	0.2	— *	—
Cigarette Tax	407	1.7	606	2.2	693	2.0
Other	1,171	4.9	1,371	4.9	1,504	4.5
Business Taxes	\$3,613	15.0	\$4,484	16.1	\$6,240	18.6
Corporation	1,746	7.2	1,660	6.0	2,002	6.0
Other	1,867	7.7	2,825	10.1	4,237	12.6
Estate and Gift Taxes	\$393	1.6	\$710	2.5	\$799	2.4
Other Taxes	\$1,091	4.5	\$492	1.8	\$337	1.0
Total Taxes	\$24,119	100.0	\$27,867	100.0	\$33,527	100.0

* Reflects elimination of hotel tax in September 1994.

Source: NYS Department of Taxation & Finance.

billion would come from increasing current tax rates, and another \$570 million could be generated by broadening the current base. The remaining revenue gains would come from adjustments to the corporate income tax (7%), sales and excise taxes (9%), the estate tax (3%), and fees and charges (2%).

Revising the Personal Income Tax

As mentioned above, the bulk of this proposal's increased revenue would be generated by changes in the personal income tax rate and structure. First, the marginal income tax rate should be increased from 6.85% to 8% for joint filers with taxable income starting at \$60,000, and it should be increased to a top marginal rate of 9% for joint filers with taxable income of \$250,000 or more. In 1997, this rate structure would have generated about \$1.77 billion in additional revenues. Some 580,000 filing units (about 10% of the total number of filers) would have been affected by the increased rates. This increase would generate approximately \$330 million from non-resident returns alone (i.e., people who live outside of New York for all or part of the year but earn substantial amounts of income in New York). This revenue estimate is based on the most recent data on the distribution of taxable incomes in New York (New York State Department of Taxation and Finance 1996, Tables 14 & 26). It is obtained by applying the increase in tax rates to the amount of taxable income above the proposed bracket levels, and it assumes that neither the level nor the rate of growth of taxable income will be affected.

The substantial cuts from New York's personal income tax have largely been achieved by reducing the top marginal rate on income. The top marginal rate was 13.5% on unearned income and 9.5% on earned income before 1987, but it had fallen to 6.85% on all income by 1997. The income level at which the top marginal rate begins is also quite low. For joint filers, the top marginal rate begins at \$40,000 of taxable income. The progressive nature of the income tax is enhanced somewhat by decreasing itemized deductions for high-income filers and by a recapture of income taxed at a lower rate. For adjusted gross income over \$100,000, taxpayers are deprived of the benefit of lower bracket tax rates on the base portions of their income.

New York has the most unequal distribution of income in the country, with high-income taxpayers receiving a greater share of total income than any other state (Citizens for Tax Justice 1996). In 1993, the top 10% of earners received over 40% of the total reported adjusted gross income. The top one-tenth of 1% of taxpayers with adjusted gross income of \$1 million or more received almost 9% of total income. In 1995, the average income of the top 1% of families was more than 25 times the average income of the middle 20% of families, as compared to a national average of 17-to-1 (Citizens for Tax Justice 1996). (The ratio for neighboring New Jersey was 18-to-1.) Moreover, the degree of inequality appears only to be increasing. Given the concentration of income among the rich, the only realistic way New York can afford even a moderate level of public spending is to impose relatively higher taxes on the wealthiest taxpayers.

New York is a state of great economic extremes. The nature of its economy and the special character of New York City, both as a residence for high-income individuals and an employment center with high economic rewards for those at the top, practically demands a more progressive income tax approach. At the bottom, poverty is higher than for the nation as a whole and more persistent. A recent analysis finds that even when taking education and other factors into account, New York has higher poverty rates than any other region of the country (Triest 1997). Despite the higher tax rates typical throughout the 1980s, the robust rate of growth of per capita personal income in New York from the 1980s to the present suggests that taxes are not an impediment to the growth of the tax base.

One reason the state can afford such an increase is that the higher tax burden would be mitigated by exporting part of the increase to both the nation as a whole and to the surrounding region. The net cost to taxpayers of an income tax increase is lower than the increase in revenues, due to the deductibility of state income taxes when filing itemized federal taxes. In 1994, 36.6% of filing units in New York itemized their deductions for the federal individual income tax (Internal Revenue Service 1996). About 91% of the 1.325 million filing units with adjusted gross incomes of \$60,000 or more chose to itemize when filing. Weighting by filing units, the average marginal tax rate for those itemizing was about 31% in 1994. The effective marginal tax rate is higher than the nominal marginal tax rate for those who fall in the phase-out range for itemized deductions and personal exemptions. Thus, the average cost to New Yorkers from the income tax increase would be, at most, about 69% of the increase in revenues, or \$1.22 billion. Only incomes of \$250,000 or more will be subjected to the highest rate of 9%, allowing 36% to 39% of the total tax increase to be exported to the rest of the nation. Of the \$1.22 billion net cost to New York

taxpayers, an additional fraction of 10% to 15% is exported to non-residents who earn substantial amounts of income in New York. Because most of the non-resident taxpayers are also itemizers, any adverse effect of the proposed increase on their willingness to commute to jobs in New York would also be dampened.

Broadening the tax base

For this tax package to be effective, not only must tax rates be raised, but the tax base must also be broadened to include Social Security benefits, in conformity with the federal treatment of Social Security. Estimated revenue from this base broadening would be \$250 million (New York State 1997, 12).

As of 1983, up to one-half of Social Security benefits are taxable at the federal level for couples with (modified) adjusted gross incomes of \$32,000 or more (\$25,000 for singles). As of 1993, as much as 85% of Social Security benefits are taxable for taxpayers with incomes exceeding \$44,000. Although New York is not among them, 15 states currently conform to the federal treatment of Social Security. Nationally, about 22% of all Social Security beneficiaries are above the threshold income levels, and pay at least some federal income tax on their benefits (Steurle and Bakija 1994, 82). Even at this level of Social Security taxation, the elderly would still be favored by the state tax code.

Pensions and annuity incomes should also be fully taxable, again in conformity with the federal income tax. Federal, state, and municipal public sector pensions are now exempt from New York state taxes. As much as \$20,000 in other pension income (\$40,000 for two married retirees filing jointly) that is typically taxed at the federal level is exempt from New York taxation for taxpayers over age 59. Though not an immediate source of revenue, in the long run such a change in the tax code would generate an estimated \$320 million.

New York is among the most generous states in its exemption of pension income. Under federal tax rules, employer contributions to pensions are taxed when the income is received by the taxpayer. The state's exclusion of pension income leads to both horizontal and vertical inequities. As for horizontal equity, it is difficult to justify excluding particular sources of income. If the state of New York wants to give a tax subsidy to the elderly, it would be cheaper and fairer to increase the personal exemption for those over 65.¹

In terms of simplicity and taxpayer compliance, closer conformity to the federal definition of adjusted gross income makes it easier for taxpayers to calculate their tax bill. Adhering more closely to the federal definition of adjusted gross income by taxing Social Security and pension income would simplify the tax code. A state constitutional amendment would probably be required to effect this change because the constitutional prohibition against diminishing retirees' pension benefits has been traditionally interpreted to include taxes.

A possible concern is that, without special tax breaks, the elderly will face unduly high tax burdens. However, a detailed micro-simulation analysis of tax burdens in New York state using 1988 data found that, at every income level except the highest, the burden of the income tax was lower for the elderly than the non-elderly. The analysis indicated that, for those with incomes between \$50,000 and \$100,000, the

average income tax burden was about 30% lower for those over 65 than it was for the average non-elderly taxpayer (Chemick and Reschovsky 1988). Although the effects of taxing pension and Social Security incomes are limited to relatively high-income retirees, it would be possible to alleviate the impact of this measure by implementing it incrementally over time.

Revising corporate income taxes

Corporate income tax codes (Article 9-A, “Franchise Tax on Business Corporations”) could also benefit from revision. The following series of small changes would increase revenue by an estimated \$150 million.² A reduction in the Investment Tax Credit (ITC) from 5% to 2% of qualifying investment would return the rate to its 1973-78 level. The minimum useful life of qualifying assets could be increased from four to seven years (which would mirror the same rules as they applied to the federal ITC before it was eliminated as part of the 1987 Tax Reform Act). Limiting the carry-forward of unused credits from 10 to five years and reducing the research and development credit from 9% to 5% would also generate more revenue.

The double weighting of receipts in the formula for determining New York’s share of the net corporate income should be eliminated. This proposal would apply to the general corporation tax, the bank tax, and the insurance tax, for an estimated revenue impact of \$58 million.

At the national level, research on the effect of the corporate income tax on businesses’ fixed investment is highly ambiguous. This is not surprising, given the difficulty of explaining this highly volatile and cyclical economic activity (Chirinko 1993). At the state level, several studies have found some effect. One study finds that, for manufacturing, tax-related differences across states in the rate of return on new investment have a statistically significant influence on plant location (Papke 1987).

Using Papke’s measure of business tax rates, New York would not be considered a high-tax state. For example, in 1977-78 the after-tax rate of return in two sample industries (furniture and electrical components) was **higher** in New York than in 17 other states, including New Jersey, Connecticut, and Pennsylvania. Since that time, the ITC was increased substantially, from 2% to as high as 6% between 1982 and 1987. Meanwhile, over the entire period, New York has continued to lose manufacturing share, even though manufacturing workers in New York have the highest ratio of value added to wages of any state in the nation (Fiscal Policy Institute 1995).

The double taxation of receipts in the state’s apportionment formula is intended to provide an incentive for firms to locate their production facilities in New York and export products to other states and abroad. A corporation that produces in New York and sells outside the state will pay a relatively smaller corporation income tax than a corporation that produces outside the state and sells its products in New York. This tax incentive lowers the cost of production in New York relative to the cost of earning income. Eighteen states currently double weight sales in their apportionment formulas (Fischer 1996). Most of the benefits of this tax expenditure are realized by only a few firms.

The double weighting of sales, combined with New York’s relatively high corporate tax rate of 9%, may create a perverse incentive for corporations that operate in more than one jurisdiction. Such corporations have an incentive to reduce their New York tax liabilities by taking advantage of transfer pricing.

Transfer prices are those charged for the internal transactions of a corporation (e.g., between the corporate parent and subsidiaries located in different states or countries). Since there is no market price for these transactions, corporations have considerable latitude in setting them in such a way so as to minimize their tax liabilities. If all jurisdictions taxed corporate profits at the same rate, then there would be no incentive to exploit transfer pricing. However, the double taxation of sales, combined with New York's relatively high statutory rate, creates an incentive for multi-jurisdictional companies to reduce sales in New York. To do this, a corporation operating in New York, as well as in other states, would be charged an artificially low price on purchases by the out-of-state division from the New York State division, while the New York division would pay an artificially high price on purchases from the low-tax state. Unfortunately, the magnitude of the transfer pricing effect is unknown. The decreasing yield of New York's corporate franchise tax, though primarily influenced by the conversion from the C to the S form and to limited liability corporations, suggests that the transfer pricing effect may also be important.

Revising consumption and use taxes³

Services: Another estimated \$63 million in revenue could be generated by expanding the base of sales taxation to include more personal services.⁴ Services to be taxed would include laundering, dry cleaning, tailoring, weaving, pressing, and shoe repairing and shining. (Several states tax such personal and repair services, including New Mexico and West Virginia. In general, the broader the sales tax base, the lower the economic distortions and the greater the revenue stability.)

Tobacco Tax: Increasing the tax on cigarettes by 6 cents per pack, from \$0.56 to \$0.62, would be little more than a 10% increase and would generate an estimated revenue of \$58 million. The estimate is based on an assumed elasticity in cigarette prices in which a 10% increase in price would lead to a 5% decrease in quantity purchased. This estimate reflects the fact that, while aggregate studies on the demand for cigarettes find that, overall, demand is quite inelastic, purchases of cigarettes in New York could decline significantly in relation to the region, especially if New Yorkers switch to purchasing cigarettes out of state.

As of January 1997, the cigarette excise tax rate was \$0.50 per pack in Connecticut, \$0.40 in New Jersey, and \$0.37 in Pennsylvania. Assuming that the cigarette tax is borne by consumers, the price differential would be \$0.22 between New York and New Jersey, and \$0.12 between New York and Connecticut. If the neighboring states left their rates unchanged, the 10% increase in New York's price might be expected to reduce state cigarette sales by more than 5%. However, the typical response to an increase in cigarette taxation has been for border states to raise their own rates in order to maintain the same taxation level. Border states tend to follow the "price leader" so as not to lose potential revenue. Although states might see some gain in revenues from an increase in cross-border sales by keeping their own rates fixed, they would stand to gain even more by increasing rates.

Alcohol Tax: Increasing rates by approximately 10% for beer, wine, and liquors would raise approximately \$30 million in revenue. Given the negative personal and social costs of alcoholism and tobacco use, a strong case can be made that both are under-taxed.

Motor Fuel Tax: Motor fuel tax should be increased from \$0.08 to \$0.10 per gallon, for an estimated revenue impact of \$52 million.

While New York has one of the lowest gasoline excise rates in the country, total taxes levied on gasoline are considerably higher. This is because the state imposes a \$0.14 per gallon tax on petroleum distributors and includes gasoline sales (net of excise taxes) in the 4% state sales tax. Thus, the proposed increase is equal to 9% of the overall excise and selective sales tax rate on gasoline and about 7% of the overall total state rate of gasoline taxation. Assuming an average price per gallon at the pump of \$1.35, the proposed increase would represent about a 1.5% increase in the price of gasoline. Because gas tax rates are high in Connecticut (\$0.39 cents per gallon) and the relative price of tolls for crossing into New Jersey has been rising, the cross-border effect is unlikely to be substantial enough to significantly affect gasoline purchases in New York. Although the increase in gasoline taxes will hit low-income drivers harder, the tax burden will still be modest, increasing total spending on gasoline by less than \$15 per year. Excise taxes have been shown to be regressive, whether income is measured on an annual or long-term basis (Lyon and Schwab 1995; Chernick and Reschovsky 1997). Consequently, the proposed increase in gas, cigarette, and alcohol taxes will impose higher burdens on the poor than on the wealthy, with the lowest 20% in the income distribution bearing nearly twice the burden borne by the highest 20%. This regressive quality of this particular part of the proposal, however, is offset by the progressive elements in the rest of the tax package.

Hotel Occupancy Tax: The hotel occupancy tax should be re-imposed at a rate of 2%, for an estimated revenue impact of \$56 million. In 1994, the state eliminated the special 5% hotel occupancy tax. At the same time, New York City reduced its hotel occupancy tax from 6% to 5%. In spite of the tax cut, revenues from the hotel occupancy tax have continued to increase. Lower tax rates, however, didn't lead to lower room rates. Room rates have risen by over 30% since the cuts, suggesting that state revenues would have grown even more if the cuts had never been made. The increased demand for hotel rooms, particularly in New York City, results from favorable exchange rates and the reduction in crime, both of which have helped bring increased tourist and business travel to New York City.

Estate Tax: Repealing both the 1995 legislation that created a \$250,000 exemption for a principal residence and the 1994 provision that created a special credit for closely held businesses valued under \$600,000 would generate approximately \$100 million in additional revenue. Repealing the 1997-98 increase in the unified credit from \$2,950 to \$10,000 and repealing the planned replacement of the current estate tax with a "pick-up" tax would avoid an estimated revenue loss of \$148 million by FY 1999-2000 (New York State Department of Taxation and Finance 1997). This estimate was obtained by applying a 4% average tax rate to the 21,000 estates filed in New York in 1995 and assuming that the average increase in the exemption from the estate tax was \$119,000.

On a lifetime basis, the estate tax is among the most progressive of taxes. Recent cuts in the tax serve only to exacerbate the increase in annual income inequality. Furthermore, the evidence suggests that the elderly pay little heed to differences in tax rates when choosing a permanent state of residence (Drescher 1994).

User Fees and Charges: All fees and charges should be increased by 5%, with the only exception being tuition at public universities. The estimated revenue impact of such an increase would be **\$70** million, derived by assuming that 38% of revenues from fees and charges are from non-tuition sources.⁵ This number, however, is only a rough estimate based on 1993 state government revenue data — the total amount of state fees and charges are difficult to determine.

User charges are desirable insofar as they represent payments for the use of public services, thus leading to a more efficient level of public expenditures. Tuition should be exempt because it has been subject to enormous increases in the recent past. Between 1990 and 1996, tuition at the State University of New York has increased at an average annual rate of more than 20% (in nominal terms), or more than double the rate of inflation. Though tuition levels may now be comparable to other state universities, tuition levels at the City University of New York are quite high in relation to average family income.

Summary

Table 2 summarizes this proposal's recommended tax increases. On balance, the proposal will increase the progressive character of New York's tax system, make revenues more responsive to economic growth, and improve horizontal equity. About 62% of the proposed revenue increase comes from raising the income tax rates and broadening the base of the estate tax (changes that are clearly progressive). These increases would help to move New York back to its traditional position as one of the more progressive state and local tax systems. Another 21% of the increase would come from broadening the base of the income and sales tax. These changes would improve horizontal equity, while imposing slightly higher burdens on lower income families. The remaining 17% of the proposed increase would come from increasing excise taxes on gasoline, tobacco, and cigarettes as well as increasing non-tuition user charges. While generally regressive in their distributional impact, these latter increases will help to promote economic efficiency and public health.

Before concluding, however, several caveats are in order. First, implementation of the base-broadening changes in the personal income tax, particularly the full taxation of state and local pension income, would require a change in the New York constitution, rendering these long-term goals. Second, since 1993, there has been extraordinary growth in the number of high-income filers and the size of their average income. Revenue estimates from increasing the personal income tax, especially the top rates, are probably underestimated, since 1993 was the last year for which these data were available. Third, the estimates of the revenue gained from an increase in fees and charges are also quite imprecise, due to the difficulty in obtaining data on fees and charges. Finally, there is a lag between implementation of tax changes and changes in revenue flows. Because New York's fiscal year ends on March 31, while the tax filing deadline is April 15, much of the revenue increase from the personal income tax changes would not be realized until the second fiscal year. This same lag time would also apply to the proposed changes in the corporate income tax and the estate taxes.

TABLE 2
Summary of Proposals to Raise Revenue by \$3 Billion in Fiscal Year 1997-98
(in millions)

Tax	Proposed Change	Revenue 1995-96	Estimated Revenue increase	Percentage of Total
Personal Income Tax	Rate increase: raise marginal rate from 6.85% to 8%, for taxable income of \$60,000 or more; raise top marginal rate to 9%, for taxable income of \$250,000 or more.	\$16,998	\$1,770*	59.4%
	Base broadening: conform taxation of Social Security benefits and pension and annuity income to federal income tax.		570**	19.1
User Taxes		\$8,328		
Sales and Use	Broaden base by taxing personal services for laundering, dry cleaning, tailoring, weaving, pressing, shoe repairing, shoe shining.	6,688	63	1.7
Motor Fuel	Increase gas tax from 8 to 10 cents per gallon.	502	65	2.2
Cigarette/Tobacco	Increase tax from 56 cents per pack to 62 cents.	693	58	1.9
Alcoholic Beverage	Increase rates by 10%.	198	30	1.0
Hotel Tax	Reimpose hotel occupancy tax at a rate of 2% for rooms over \$100 per night.		56	1.9
Other		245		
Business Taxes***		\$5,710		
Corporation Income Tax (Article 9-A Franchise Tax)	Reduce investment tax credit from 5% to 2%; increase minimum useful life from 4 to 7 years; limit carry-forward of credits to 5 years; eliminate double weighting of receipts in apportionment formula.	1,821	\$150****	5.0
Corporation, Bank, Insurance		2,210****	\$58	1.9
Estate & Gift	Repeal \$250,000 exemption for principal residence; repeal special credit for closely held businesses valued under \$600,000.	\$799	100	3.4
Fees and Charges			\$70	2.3
Total		\$33,528*****	\$2,979	100.0%

* Estimate is based on 1993 data inflated to 1997 dollars.

** Change in state constitution would be required to tax the pensions of state employees.

*** Bank and Corporation and Utility tax revenue.

**** The estimate comes from the Tax Expenditure Report, 7993-94 (New York State Division of the Budget and Department of Taxation and Finance 1994). The cost of the credit was inflated to 1997 dollars at an annual rate of 5%.

*****Total is for tax revenue. Excludes revenue from fees and charges.

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Endnotes

1. A possible justification for the exemption of state and local pension income is that such pensions are not indexed to inflation, and the exemption serves to offset the decline in the real income of public employees over the course of their retirement. Even so, it would still be more efficient and more equitable to provide for this need through direct indexation rather than through a tax expenditure.
2. This estimate comes from the *Tax Expenditure Report, 1993-94* (New York State Division of the Budget and Department of Taxation and Finance 1994). The cost of the credit was inflated to 1997 dollars at an annual rate of 5%.
3. A word of precaution is in order for increases in excises, such as tobacco, alcohol, and gasoline. It is quite likely that these revenues will grow more slowly over time than state personal income and public expenditures, so the increases proposed here would need to be augmented in some way to maintain revenue levels over an extended period of time.
4. The estimate comes from the 1997-98 *Tax Expenditure Report for New York State*.
5. Tuition and fee payments are taken from State of New York (1996, 120), while total changes are taken from U.S. Bureau of the Census (1994).

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